ployed in keeping the books of such taxpayer; but if * * * the method employed does not clearly reflect the income, the computation shall be made in accordance with such method as in the opinion of the Commissioner does clearly reflect the income".

Section 7454 of Title 26 of the United States Code provides in part as follows:

". . . In any proceeding involving the issue whether the petitioner has been guilty of fraud with intent to evade tax, the burden of proof in respect of such issue shall be upon the Secretary or his delegate".

STATEMENT OF THE CASE

This suit arises from the contested federal income tax liability of petitioners, husband and wife, for the years 1942, 1944, 1945, 1946 and 1947. The Commissioner determined deficiencies for these years and imposed 50 per cent civil fraud penalties. The Tax Court rejected the determinations of the Commissioner for the year 1942 but sustained this determination with respect to the years 1944-1947 (with minor adjustments).

Petitioners are residents of a small community of 600 persons in Iowa. Petitioner Harry Schroeder was born and raised on a farm and has been a farmer for all his adult life, specializing in the grazing and feeding of cattle. (R. 435)

Although he has only a sixth grade education, Petitioner Harry Schroeder kept his own records, with the help of his wife. His tax returns were prepared by area people who held themselves out as competent in this work. The tax returns involved in this case were prepared by one Moseley, a man who operated a small business selling feed, except that early each Spring he prepared approximately a thousand federal income tax returns for his neighbors. (R. 61-64) The complete good faith and integrity of Moseley was not questioned.

Moseley was fully familiar with the Petitioner's operations and was given all records which he requested or required to prepare the tax returns. (R. 64, 85) As District Judge Davies, in his Opinion for the Eighth Circuit Court of Appeals, stated, no formal books were kept, but all of the records of purchases, sales, checks, bank statements and similar written material were intact.[2] (App. p. 3a) Concededly, no cash transactions are involved.

As is the custom and necessity in the industry, livestock was commingled both in pasture and in feed lot. (R. 436)

But at the end of each year, Petitioner Harry Schroeder made his own visual check to determine his inventory of livestock (R. 146) Immediately thereafter, and within a matter of days, Petitioner would meet with Moseley to prepare his tax returns. (R. 64) Basing his computation on the actual, factual head count, the physical inventory of cattle made by Petitioner at the beginning of each year, Moseley used the cancelled checks and other original records of the taxpayer to compute the dollar value of the number of cattle represented by this physical head count, assuming that the first cattle purchased were the first cattle sold.[3] (R. 95) In other words, if Petitioner actually saw that he had one thousand head of cattle in the field on December 31, Moseley would work back from December 31 and ascertain the cost of the last thousand head of cattle purchased by the Petitioner in the preceding

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[2] This method of record-keeping conformed to the general practice of the farmers and feeders in the area and was in accordance with the regulations prescribed by Respondent (R. 255, 256, 395; Regs. 111 § 29.54-1 and § 29.22(a)-7).

[3] The reason for this detailed description of Petitioner's method of arriving at the opening inventory, is the fact that the radically different "method" of the Commissioner—using theoretical, arbitrary cut-off dates and "plugged figures" has been mis-described below as "similar".

year, an application of the traditional and fully acceptable "first-in, first-out" inventory method.

In each of the years under review (though not at year-end), physical inventories were taken by the Livestock National Bank of Omaha, Nebraska, which inventories can be reconciled to the Moseley (but not to Respondent's) inventories, thus affording an independent, unbiased and thoroughly reliable check of Petitioner's head counts.[4] The Closing Net Worth in the case was stipulated.

Thus, this case squarely presents a situation where a computation was made by the Net Worth Method but where the Closing Net Worth is agreed to by both parties. The only issue, then, is the Opening Net Worth in each year. The inherent difficult of the situation arises from the fact that most of the net worth of the taxpayer at any time was in his livestock inventory.

Accordingly, the inventory of the Commissioner obtained by guesswork, not only distorts the net worth computation of income, but becomes virtually impossible to disprove. The only inventory methods which can reflect true income, are methods proven by industry experience and bottomed on head counts tied to cost records.

On July 13, 1951 (or more than seven years after the events in question), Respondent determined tax deficiencies against Petitioners, exceeding $500,000. (R. 9-10) These

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[4] In order to finance these cattle feeding operations, Petitioner at various times mortgaged between 20% and 80% of all cattle he purchased by purchase money mortgages. Net Worth statements, on the forms prescribed by the Federal Reserve Bank, were prepared by a bank officer with the assistance of Petitioner and the factual information thereon (particularly the amount of livestock owned by Petitioner) was independently verified through physical inspection by bank inspectors (R. 196; 200; 201; Exh. 19; Exh. "O"). The correctness of these annual statements, contemporaneously made and independently verified, was conceded in open Court by Counsel for Respondent (R. 406).

deficiencies were "determined" solely and exclusively on the basis of a purely theoretical and factually incorrect computation of Commissioner's agent, (Exh. "A", "P" "B"), setting the principal item (the livestock carry-overs) arbitrarily, artificially, inflexibly and incorrectly by simply taking Petitioner's purchases of the last 90 days in each taxable year (R. 340-3), without regard for actual head-count, variations in feeding-time or any other business or economic reality. (R. 379-80)

This inventory method is dignified by use of the generic term. The Commissioner's agent who made the determination testified that despite his years of service and examining the tax returns of farmers and livestock feeders, he never recalled any return in which the method he applied to Petitioner's re-computation was used. Nothing in the regulations of the Treasury Department or in its directives or bulletins authorized the use of such an inventory method. The agent further testified that he used this method only because it gave him "the best figure that could be obtained". (R. 355-58) When asked why he used a 90-day inventory period rather than some other length of time, he testified "between 90 and 110, I probably could have used probably any number of days in-between there". (R. 383)

Furthermore, he testified that he used the 90-day figure instead of 110 because "I thought it would benefit the taxpayer". That the use of the shorter period would benefit the taxpayer is a palpable falsehood as is clearly shown by the Record. As the Appeals Court stated, the livestock was often purchased in quantities as large as two thousand head. (App. p. 2a) As the record as a whole shows, the use of a 110-day inventory method by the Commissioner would have eliminated any additional tax liability of the Petitioners.

The Commissioner's agent further admitted that although he ascertained by his investigation that a large proportion of the taxpayer's inventory was mortgaged, he did not

examine the official and contemporaneous mortgage records of the State of Iowa in order to ascertain the validity of his figures. (R. 361, 370) The Tax Court found and the Appeals Court emphasized that "Petitioner financed his cattle purchases with loans, and a part of approximately 80 per cent of his purchases was mortgaged". Adopting that figure and applying it to the records of the State of Iowa which were introduced as exhibits at the trial, the following figures are obtained:

HARRY SCHROEDER

Chattel Mortgage Records

Mortgagee	Mortgage amount	No. of days held
Dec. 31, 1943 (outstanding as of)		
Livestock-National Bank	$ 22,500.00	167
" " "	32,500.00	150
" " "	75,000.00	149
" " "	60,000.00	196
" " "	36,000.00	173
" " "	21,500.00	92
First State Bank Tabor, Iowa	25,000.00	119
		1046

1046 days ÷ 7 mortgages = 149.4 days average number of days held.

Dec. 31, 1944 (outstanding as of)		
Livestock National Bank	100,000.00	188
" " "	94,937.77	147
" " "	110,000.00	218
		553

553 days ÷ 3 mortgages = 184.3 days average number of days held.

Mortgagee	Mortgage amount	No. of days held
Dec. 31, 1945 (outstanding as of)		
Livestock National Bank	150,000.00	111
" " "	100,000.00	145
" " "	60,000.00	138
		394
394 days ÷ 3 mortgages of days held.		= 131.3 days average number
Dec. 31, 1946 (outstanding as of)		
Livestock National Bank	100,000.00	456
" " "	100,000.00	108
		564
564 days ÷ 2 mortgages of days held.		= 282 days average number

(R. 598-600)

Conversely, a Certified Public Accountant with 28 years' accounting experience in the cattle feeding business, another Certified Public Accountant who had managed farms and audited books of many farmers and cattle feeders, and a former President of the Livestock National Bank of Omaha, all testified that this theory of "determining" livestock carry-overs by arbitrarily taking the last 90 days' purchases, had never been used in all of their experience, was illogical and misleading in view of the fact that all farmers and cattle feeders had to feed their cattle in excess of 90 days, and because market conditions caused varied feeding times from year to year. (R. 199, 201, 202, 277, 417).

The documentary evidence consisting of mortgage records and liability ledgers also proved conclusively from a dollar and cent point of view that this theoretical "computation" of livestock carry-overs had to be and was completely incorrect. These records, for the years in issue, showed that the actual cost of mortgaged cattle alone ex-

ceeded in value the amount of cattle "determined" as the livestock carry-over by Respondent's hypothetical method (Exh. 29, R. 365, 368-370).[5]

One specific example involves the crucial opening net worth. The Findings of the Tax Court itself on their face show:

1. Petitioner's accountant determined a livestock inventory of $800,094.87 for December 31, 1943. This was determined by the traditional first-in, first-out inventory method in January 1944. (R. 437)

2. Commissioner, using his arbitrary and inaccurate method, redetermined a livestock inventory of $259,892.30 for December 31, 1943 (R. 6*2)

3. Commissioner, accepted the mortgage record figures for December 31, 1943 which showed that this very same livestock inventory of December 31, 1943 was encumbered by purchase money mortgages in the amount of $295,529.08, or approximately $40,000 in excess of Commissioner's total hypothetical cost of inventory. (R. 376-78, 602)

4. The Courts below upheld this obvious fallacy despite their specific Finding that only 80% of Petitioner's livestock inventory was subject to mortgages and that on this 80%, the money loaned, of course, constituted only a fraction of its cost. (App. p. 2a)

In sustaining the Tax Court, Judge Davies apparently relied wholly on the Findings made by that Court without examination of the Record. Both Courts made the amazing statement that the method used by the Petitioner and

[5] The Court below on the basis of this very evidence, did reject Respondent's hypothetical "determination" for the year 1942, as unsound, but, illogically enough, accepted Respondent's theoretical determination for the other years (R. 461-463), although equally contradicted by equally irrefutable evidence.

his accountant in arriving at the year-end cost of the inventory was "similar" to that used by the Commissioner. The very opposite is true. Moseley got an actual head count from Schroeder. (R. 91, 146, 147). This head count was made contemporaneously by the man who, as the court found (R. 438) visited his feed lots every day and handled all his own transactions,—the man who knew how many steeds he had bought and how many steers he had sold, who could—and did—tell Mosely to the last steer, how many there were on his lot on January 1 of each year.

All Moseley did was to translate this count into dollars by carefully checking out the preceding year's purchases. As a result of this, he reached varying dates. Sometimes it was in August (150 days prior to December 31) (R. 95); sometimes it was another date, but never earlier than September 15 (105 days). But the cut-off date was the result and not the starting point. Clearly the MOSELEY method was as dissimilar from the Commissioner's method as words can describe it. For, the head count on December 31, the most important factor—unknown in Commissioner's calculation—was known in Moseley's. The day on which the first of the inventory steers was purchased was a variable date for Moseley. It changed every year: "there was no pattern". R. 95) The Commissioner substituted an arbitrary and unvarying[6] date for the most important variable: feeding time, ignoring grazing time completely. Thus the dollar value of the December 31st

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[6] It should be noted that because of taxpayer's volume of purchases, a few days make a substantial difference in computing inventory. Exh. 28 shows that in 1943, 777 head of cattle were mortgaged on the 33rd day preceding the end of the year. In 1944, 2000 head were mortgaged on the 130th day, and in 1945, 2500 were mortgaged on the 95th day. Since these figures refer only to mortgaged cattle and taxpayer's dollar purchases far exceeded the total of partial mortgages on a part of his livestock, several hundred thousand dollars could be added to the inventories by extending the period backwards for only a few days more than the arbitrary 90 used by Respondent.

inventory became the result of arbitrary determination, instead of mechanical translation from actual head of cattle into dollars.

Civil fraud penalties were imposed as part of the determination of the Commissioner for all the years involved. A Finding of "Consistent Understatement of Income" upheld these penalties below.[7] The Tax Court simply found that the alleged consistent understatements of income were not disapproved by Petitioners and the "Presumption of Correctness" carried through every taxable year (except 1942).

Summarizing, the essential facts are as follows:

1. The Commissioner without any reason which appears in the Record, deliberately disregarded the opening livestock inventories of the taxpayer prepared by his accountant in accordance with the traditional first-in, first-out method sanctioned by experience and law. If the Commissioner had used the taxpayer's inventories in his net worth computation, there would have been no additional tax liability.

2. The Commissioner in making his net worth determination, substituted completely arbitrary and unreasonable inventory figures arrived at by using the cost of the taxpayer's purchases during the last 90 days of each year. This method had no basis in, but on the contrary was in open conflict with, the actual experience of the taxpayer and his industry.

3. The Courts below upheld and approved the Commissioner's method of estimating inventories and the result-

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[7] The Tax Court refers to substantiating "evidence" involving the change of memoranda on some 20 cancelled checks. During the investigation, at the suggestion of the Commissioner's own agent, an accountant hired by the taxpayers to help the agent, mistakenly redesignated certain expenses of prior years. None of this even remotely affected any of the income tax returns, nor were the Petitioners in any way involved.

ing deficiencies in spite of the concession of the Commissioner that his inventories were guesswork; and in spite of documentary evidence showing these figures to be inconsistent with official ledgers and public mortgage records.

4. On the basis of the Presumption of Correctness of this arbitrary determination of an alleged understatement of income for a number of taxable years, the Court below upheld a finding of Civil Fraud solely upon Petitioner's alleged failure to overcome the Presumption of Correctness of this determination by disapproving the Commissioner's income figures.

5. The opening net worth determination of the Commissioner--predicated entirely upon his hypothetical inventory—is virtually impossible to disprove. As is customary in all business, the taxpayer kept only those records required to establish inventory by a traditional and accepted method. He did not keep a perpetual, or actual, inventory as might the automobile dealer; that is, he did not keep a specific record of each animal. But, as the record shows, this is not the practice of the industry. However, the inventory method chosen by the taxpayer has withstood the test of time and is normally accepted by the Commissioner. Yet, not being an exact inventory method, the results obtained therefrom can never be used to disprove some other figure arbitrarily selected. Thus, the Commissioner in this case made a deficiency determination by guesswork and fiat, which, though illogical and patently false, the courts below have held stands because no one can ever fully disprove it.

REASONS FOR GRANTING WRIT

It is submitted that the questions presented by this case are fundamental, striking to the very heart of the never-ending tug-of-war between the preservation of revenues for the State and the respect for individual rights of the citizen. No case involving civil tax liability under

the Net Worth Method has ever been reviewed by the Supreme Court of the United States, although in criminal cases, this Court has recognized the inherent dangers lurking in the Net Worth theory. Every citizen of this Republic is subject to its income tax laws, and it is recognized that the use of the Net Worth Method has increased geometrically since this Court's Opinion in the case of *Holland* v. *United States*, 348 U.S. 121 (1954). In a sense, the questions presented herein revisit *Holland*. But they also seek a determination by this Court of the principles to be applied in the infinitely broader field of civil tax liability. It is believed that in no case could the basic issues be more strikingly illustrated than in the case at bar.

1. "No case civil involving liability under the Net Worth Method has yet come before the Supreme Court and there is a *basic unresolved conflict among the Circuits*:—on the one hand, to make the taxpayer disprove a deficiency determined by the Commissioner; and, on the other, to protect the taxpayer against an arbitrary determination which may be virtually impossible to disprove."

—I Rabkin & Johnson, Federal Income, Gift and Estate Taxation, p. 1227(b), (Sec. 1203(4)).

Ever since this Court approved the use of the Net Worth Method in criminal prosecutions in its landmark decision in *Holland* v. *United States*, 348 U.S. 151 (1954), the lower Courts and some of the Circuit Courts of Appeal, (while paying lip service to the warnings expressed by this Court) have blindly approved the most arbitrary and careless application of this Method to civil tax cases. Ignored are fundamental distinctions. In criminal tax cases the Commissioner does not have a presumption of correctness and is trying only to prove circumstantially that some tax was not paid. In civil tax cases, the Commissioner makes an administrative dollar and cents determination of tax due which is prima facie correct and which the taxpayer has to disprove. Certainly, this latter situation requires more than approximations and guesswork. But, reasoning that

an approval by the Supreme Court of the Method in criminal prosecutions means *a fortiori* approval of the Method in civil cases, with a corresponding relaxation of the restraints urged, the inability of the taxpayer to disprove an arbitrary net worth computation by the Commissioner has resulted in rubber stamp approval of the most arbitrary deficiency determinations in the Eighth and Third Circuits, while the First, Fifth, and Sixth hold that a determination based on guesswork is not entitled to the presumption of correctness.

Proving the old adage that "hard cases make bad law", many of the cases appealed and reported are those of gamblers and racketeers. The legitimate business taxpayer in many of the Circuits now is faced with a solid body of precedent for the proposition that, inability to disprove a virtually undisprovable net worth determination, undisprovable in spite (and in this case because) of its arbitrariness, means economic ruin.

The conflict in the Circuits is illustrated graphically by the following excerpts from representative opinions below:

"The Commissioner's determination of a deficiency is prima facie correct, and the burden is upon the taxpayer to disprove that determination."

—*Schroeder* v. *Commissioner*, 291 F. 2d 649. (C.A. 8, 1961)

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"The Commissioner's determination of the amount of taxpayer's income and the existence of a deficiency is prima facie correct. The burden is on the taxpayer to disprove the Commissioner's determination".

—*Marcella* v. *Commissioner*, 222 F. 2d 878, at 881 (C.A. 8, 1955)

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"If respondent is to be permitted to make an arbitrary guess as to the proper figure for the cash on hand account, there would seem to be no reason as a general proposition why similar guesses should not be made as to each of the constituent elements comprising the taxpayer's net worth. Under these circumstances the entire net worth technique becomes nothing but an elaborate accounting sham lending semblance of system and logic to a determination of deficiency which could have no greater validity than the orginal guesswork upon which it was based.

". . . We think it is of equal importance in a civil case to show that the taxpayer's net

"This being a civil action, the determinations of the Commissioner have *prima facie* validity. Holland v. United States, 348 U.S. 121, 126, 75 S. Ct. 127, 99 L. Ed. 150. The petitioners have the burden of overcoming the presumption that the Commissioner's determinations were correct."

—*Shahadi* v. *C.I.R.*, 266 F. 2d 495, at 500 (C.A. 3, 1959)

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worth increases are attributable to currently taxable income."

—*Thomas* v. *Commissioner*, 232 F. 2d 520, at 526 (C.A. 1, 1956).

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"In short, the Commissioner's determination is presumed correct, but if error is shown, the presumption disappears and the Commissioner then has the burden of proving the correctness of his determination, or at least the correct amount actually due.

—*Harp* v. *C.I.R.*, 263 F. 2d 139, at 141. (C.A. 6, 1959)

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"In proceedings before the Tax Court, as distinguished from suits for refund in the District Court, the taxpayer is not required to show the correct amount that lawfully might be taxed against him, but it is sufficent to show that the Commissioner's determination is invalid. [Citations omitted].

"In Thomas v. Commissioner, supra, we reversed the decision of the Tax Court in a net worth case because of the strong underlying element of guesswork involved in the Commissioner's determination. In Harp v. Commissioner, 6 Cir., 263 F. 2d 139, decided February 11, 1959, the Commissioner's determination was sustained by the Tax Court because of the failure of the taxpayers to go forward with the proof and supply information about their assets which would warrant changing the Commissioner's determina-

tion. We reversed this ruling, pointing out that under Holland v. United States, supra; Durkee v. Commissioner, supra; and Thomas v. Commissioner, supra, the Government's evidence was insufficient to meet the requirements imposed upon it in net worth cases. In view of the evidence in this case above referred to, we reach the same result. . . ."

—*Polizzi* v. *C.I.R.*, 265 F. 2d 496, at 502. (C.A. 6, 1959)

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". . . the process of net worth reconstruction is a delicate one and may be used with assurance only when it seems certain that all factors have been properly treated and evaluated . . ."

—*Schultz* v. *C.I.R.*, 278 F. 2d 927 at 934 (C.A. 5, 1960)

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To the same effect: *Thomas* v. *C.I.R.*, 266 F. 2d 297 (C.A. 6, 1959)

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2. The Commissioner should not be permitted to rely on the presumption of correctness in civil tax cases where he abuses the net worth method with arbitrary determinations and ignores relevant facts and leads.

The Commissioner has relied on the approval by this Court of the use of the net worth method in criminal cases to apply the method in civil cases. He has taken "the little finger" this Court gave him in Holland, permitting reconstruction of income by approximation and reached for "the whole hand" in arbitrarily guessing at each component item of this reconstruction, ignoring all facts and leads offered by the taxpayer. (e.g., R. 376, 598-600)

Even in criminal cases, where the government has the burden, this Court in *Holland*, supra, insisted upon an investigation of relevant facts and leads to prevent injustice.

In civil cases, and in this case in particular the Commissioner employs approximations and circumstantial inferences, but ignores such incontrovertible facts as public mortgage records. The Commissioner's agent testfied that he visited Iowa County Courthouse to check titles but didn't bother to check mortgage records although he realized that most of taxpayer's livestock inventory was mortgaged in part. (R. 370)

The law must be clearly laid down that the Commissioner cannot have his presumption of correctness and his careless approximations, too. He should be admonished that he cannot misinterpret or erode the teaching of *Holland*, supra, simply because he is transposing those teachings to a civil case. The Court of Appeals for the Eighth Circuit failed to do so; pronouncement of the applicability of *Holland* to Civil Tax Cases by this Court seems urgently required.

3. Respondent's statutory burden to prove fraud has been consistently and illegally shifted to the taxpayer by the Circuit Courts of Appeal (and particularly by the Court below) where a finding of civil fraud was sustained on the basis of a "consistent understatement of income", the determination of which, in turn, was sustained solely because of taxpayer's inability to overcome the presumption of correctness of Respondent's determination.

The Court below approved and adopted the Tax Court's Opinion with regard to the fraud issue. The Court held and quoted the Tax Court to the effect that, "there were consistent understatments of income of a substantial nature over the years before us . . ." and further held that these understatements were "demonstrated by the net worth computation . . . prepared by the respondent . . .". These net worth computations, arbitrary and inaccurate

as they were, in turn were sustained by the Court of Appeals only because "the Commissioner's determination of a deficiency is prima facie correct, and the burden is upon the taxpayer to disprove that determination." (App. p. 6a)

Thus, by a neat sleight-of-hand, fraud was proven because of Petitioner's alleged inability to overcome the presumption of correctness of Respondent's determination of an understatement of income for several consecutive years.

If the Court below is upheld, the Statutory burden of proof will have been shifted and illegally so: no evidence whatever, "clear", "convincing" or otherwise, was introduced by Respondent in support of his computation of Opening Inventories, Opening Net Worth, and taxable Income. The opening inventories in Exhibits A and B, unsupported as they were by either worksheets, documentary evidence, or supporting records, were sustained below only on the presumption of correctness, and there is no specific finding of fact by the Tax Court as to any other evidence on which the Opening Net Worth statement is based.

Assuming arguendo (and indeed without so conceding) that the Tax Court was correct in sustaining the Commissioner in his determination of the deficiencies on the basis of the Presumption, the Court was clearly in error when going this additional step of using the deficiencies thus sustained—not on proof adduced by the Respondent,—but on the Statutory Presumption of Correctness, to find "consistent understatement" and resulting fraudulent intent. In *Carter* v. *Campbell*, 264 F.2d 930, at 936 (C.A. 5, 1959), the Circuit Court of Appeals for the Fifth Circuit held:

> "Where the case involves both a deficiency and a civil fraud penalty, each party has its own peculiar burden of proof. The result is, as we once pointed out, Snell Isle, Inc. v. Commissioner, 5 Cir., 1937, 90 F.2d

481, certiorari denied 302 U.S. 734, 58 S.Ct. 120, 82 L.Ed. 568, the case may end in a standoff from the failure of each party to go ahead with his evidence. The taxpayer fails on the deficiency. The Government fails on the fraud penalty. Failure of the taxpayer to overcome the deficiency does not create a presumption of fraud."

In the case at bar, the entire alleged "understatement of income" is based on the Presumption of Correctness. Thus, the holding of the Court of Appeals for the Eighth Circuit is in clear conflict with that of the Fifth Circuit. The Court below holds that where an understatement of income for several consecutive years is sustained because of the Presumption of Correctness, fraud can be proven by this failure of the taxpayer to overcome the presumption. The Fifth Circuit clearly holds to the contrary: this Court should re-affirm the law to the effect that the Commissioner cannot shift the burden of proof by this "boot-strap" operation: an arbitrary determination that there is an understatement of income for a number of years, the presumption that this "determination" is correct, imposition of the heavy 50% fraud penalty and the infamous tag of fraudulent tax evader, because the taxpayer was unable to disprove a hypothetical deficiency assessment for several consecutive years.

CONCLUSION

4. The liberty and constitutional rights of 60,000,000 taxpayers —citizens require a mandate by this Court establishing the limits to which the Commissioner can go in determining a prima facie correct dollars and cents tax liability by arbitrary assessement instead of accounting computations or reasonable reconstruction.

It is submitted that in the within case, the problem is so severely etched as to require a clear-cut mandate which even the gigantic, hydra-headed revenue department could not confuse or distort.

In its simplest form the factual situation boils down to a $500,000 deficiency. This deficiency was obtained by abusing the net worth method to misreconstruct the income of a farmer who kept all of his basic records but no formal books. This abuse of the net worth method alone yielded the deficiency because in the opening net worth the taxpayer's inventory was arbitrarily reduced from $800,000 to $259,000—thus the $500,000 deficiency. The reduction was made by wholly ignoring the inventory of the taxpayer and, arbitrarily, and without basis in fact or theory, assuming that that inventory was identical with the cost of the last 90 days purchases of the previous year. Not only is the taxpayer's inventory ignored, but industry experience, public records and all other relevant indicia are ignored. Even contradictory components of the Commissioner's own net worth computation were ignored by the Courts below. For the Commissioner baldly asserts, and the Courts below accepted, that a part of 90 days purchases at a cost of $259,000 were financed by purchase mortgages of $295,000 (or 120%), the perfect non sequitur.

In its simplest form the legal question involved is how far the Commissioner shall be permitted to use guesswork, arbitrary assumption, and unrealistic estimate, in order in the very words of the Tax Court in this case to implement his credo that "the job must, in some fashion,

be done". Is there a point where the net worth method, abused and applied without restraint, makes this "job", the job of finding a deficiency, rather than ascertaining true liability? Is there a point where enforcement of revenue collection impinges on due process and is inherently confiscation of property? Are there no limits to the abuse of this net worth method? May "approximation" deteriorate into complete accounting sham and arbitrary determination of liability out of thin air.

This Court has stated that the net worth method is not a method of accounting. This Court has permitted the net worth method to be used in criminal cases. Even in these cases this Court has demanded vigilance, has reminded of the inherent evils of the net worth method, and rather than give the government any presumption of correctness, has urged the Appellate Court to be vigilant that the presumption of innocence of the taxpayer be jealously guarded.

But from the clear mandate of *Holland, supra* and the cases following, the Commissioner and some lower courts have by tortuous thinking arrogated to the Commissioner the right of unrestricted license in civil tax cases where the Commissioner ordinarily has a presumption of correctness. The Commissioner not only asserts that he can use the net worth method whenever he makes an administrative determination that it is necessary but he asserts also that he can arbitrarily set each component regardless by what method or on what basis. His assessment, whether based on fact or on whimsy becomes clothed with the presumption of correctness. The taxpayer has the burden to prove it incorrect. According to the Court of Appeals for the Eighth Circuit it is not enough to show that the method employed by Respondent was illogical, arbitrary, erroneous or even capricious—the determination, the very dollar and cent figures must be disproved. A premium thus is placed on Respondent's determining deficiencies by devious and

theoretical methods: the more esoteric the method the more nearly impossible it is for the taxpayer to disprove its Frankenstein result.

For the above reason it is prayed that the petition for the Writ of Certiorari should be granted.

Respectfully submitted,

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Of Counsel

DATED: November 20, 1961

APPENDIX

UNITED STATES COURT OF APPEALS
FOR THE EIGHTH CIRCUIT

No. 16,439

HARRY AND AMANDA SCHROEDER, *Petitioners*,

v.

COMMISSIONER OF INTERNAL REVENUE, *Respondent*.

On Petition to Review Decision of the
Tax Court of the United States.

[June 23, 1961.]

Before VOGEL and BLACKMUN, Circuit Judges, and DAVIES, District Judge.

DAVIES, District Judge.

This case comes to us on petition of Harry and Amanda Schroeder for a review of the decision of the Tax Court of the United States, 16 TCM 707, Amending Order 17 TCM 836, which sustained a determination by the Commissioner of Internal Revenue of deficiencies in the income taxes of Harry Schroeder for 1944 and 1945 and of deficiencies in the income taxes of both petitioners for 1946 and 1947. Addition to tax was determined under §291(a) for

the year 1946 for failure to file a return as required by §51(a) within the time prescribed, and further additions were determined for the years 1944 through 1946 under §293(b) because of fraud with intent to evade tax.

The petitioners are residents of Tabor, Iowa, where Harry Schroeder has been engaged in cattle feeding a good share of his life. Although the petitioner dealt in other animals, most transactions herein concerned cattle which were purchased from livestock commission merchants, brokers and dealers. Normally, two and three year old grass fed cattle were selected, the number purchased at any one time ranging from a few dozen to more than two thousand head. These cattle were placed in feed lots for periods from thirty days to four or five months before being marketed. Immature cattle were grazed until ready for feed lots, and as many as twenty months could elapse between time of purchase and sale. The cattle were commingled in various feed lots irrespective of purchase date or price paid. Petitioner financed his cattle purchases with loans, and a part of approximately eighty per cent of his purchases was mortgaged.

Petitioner Harry Schroeder reported his annual income on a cash receipts and disbursements basis, deducting from gross receipts the computed cost of cattle sold in that year without regard to purchase date. Cost of the livestock sold was based upon an estimate prepared by petitioner and his accountant. In preparing the estimate a cutoff date was chosen, usually on or about September 15th, it being assumed that all cattle purchased after that time were on hand at the end of the year. The 1945 return indicated that the livestock carry-over from 1945 to 1946 was $680,010.70. On the 1946 return the livestock carry-over from 1945 was $496,281.05. The return for 1946 showed a livestock carry-over to 1947 in the amount of $605,300.58. The return for 1947 shows a livestock carry-over from 1946 of $555,168.88.

No separate records or identification of the various herds were maintained although petitioner visited the feed lots almost every day and was familiar with the types and number of cattle there. No formal books were kept of feeding operations, the records consisting of bank statements, liability ledger sheets, canceled checks, bills of sale and purchase invoices. Most of the business was handled by telephone with no records or memoranda being made of the transactions. Not all of the proceeds from cattle sales were deposited in bank accounts, some being applied directly on notes payable to banks. The only actual head count of livestock taken was in September of 1947 when the petitioner formed the Harry Schroeder Cattle Co., Inc., and Harry Schroeder, Inc.

A thirty day extension of time in which to file an income tax return for 1946 was obtained by petitioner and a tentative individual return filed April 15, 1947, disclosing a net income of $51,500.00 and tax liability of $25,479.00. The return contained no computation of gross receipts, cost of livestock sold or gross profits, and no schedules showing computation of net income. On July 15, 1948, a joint return for 1946 was filed which did contain a schedule reflecting gross receipts, cost of livestock sold, gross profits, net income and which disclosed tax liability of $185,374.14.

The Commissioner computed petitioners' taxable incomes for the years involved by alternate methods, net worth and by a statement of income and expense, both computations reaching the same total taxable incomes. The sources of both computations were basically the same, the principal disputed item being the cost of livestock on hand at the beginning of each taxable year. Since error in either computation will be reflected as well in the other, our discussion will be limited to that of the net worth method. Because of petitioner's failure to make regular physical head counts, the Commissioner worked backward from the actual head count taken in 1947 and, using petitioner's records

and memoranda, established a cost basis of livestock on hand December 31, 1946. To determine this for livestock on hand as of December 31, 1944 and 1945, respectively, it was assumed that all livestock purchased in the last ninety days of each year were still on hand at the end of that year.

The Tax Court held that (1) the Commissioner was justified in adopting the net worth method of computing petitioners' income, (2) the lack of proper record keeping compelled the use of the ninety day cutoff in determining the livestock carry-over, (3) a part of the deficiencies for each of the years 1944 through 1946 was due to fraud with an intent to evade tax and (4) petitioners were liable for additions to tax for failure to file a timely return for the year 1946 within the meaning of §51(a), Internal Revenue Code of 1939.

> "[7] Decisions of the Tax Court are to be reviewed by the same standards as are applied to decisions of the district court in civil cases tried without a jury. Findings of fact by the Tax Court shall not be set aside unless they are clearly erroneous. *Greenspon* v. *Commissioner*, 8 Cir., 229 F.2d 947, 949; *Omaha Nat. Bank* v. *Commissioner*, 8 Cir., 183 F.2d 899, 902, 25 A.L.R.2d 628; *Doll* v. *Commissioner*, 8 Cir., 149 F.2d 239, 247." *Luehrmann's Estate* v. *C. I. R.*, 287 F.2d 10, 15, (8 Cir.).
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> "• • • A finding is 'clearly erroneous' when although there is evidence to support it, the reviewing court on the entire evidence is left with the definite and firm conviction that a mistake has been committed." *United States* v. *Gypsum Co.*, 333 U.S. 364, 395.

It is unnecessary for the Commissioner to show that inadequate books and records have been kept by the taxpayer before resorting to the net worth method of computing taxable income for the years in question. *Holland* v. *United States*, 348 U.S. 121, 75 S.Ct. 127, 99 L.Ed. 150.

In *Schultz* v. *C. I. R.*, 278 F.2d 927, 929, the Court said:

> "[1-3] The Taxpayer insists that under §41[2] the net income is to be computed in accordance with the method of accounting regularly employed by a taxpayer. Consequently, where a taxpayer keeps books and records, the Commission has the burden of first establishing that the records are faulty or either negligently or fraudulently fail to reflect items of income or disbursements. But this is clearly not so. This Court, with many others, is conscious of the dangers in the use of the net worth method[3] and will require

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"[2] '§ 41. General rule

"'The net income shall be computed upon the basis of the taxpayer's annual accounting period (fiscal year or calendar year, as the case may be) in accordance with the method of accounting regularly employed in keeping the books of such taxpayer; but if no such method of accounting has been so employed, or if the method employed does not clearly reflect the income, the computation shall be made in accordance with such method as in the opinion of the Commissioner does clearly reflect the income. • • • ' 26 U.S.C.A. § 41 [1939 I.R.C.].

"Somewhat related is § 54 of the 1939 Code, Records and Special returns:

"'(a) By taxpayer. Every person liable to any tax imposed by this chapter or for the collection thereof, shall keep such records, render under oath such statements, make such returns, and comply with such rules and regulations, as the Commissioner, with the approval of the Secretary, may from time to time prescribe.' 26 U.S.C.A. § 54 [1939 I.R.C.].

"[3] *Bryan* v. *Commissioner*, 5 Cir., 1954, 209 F. 2d 822, 826; *Polizzi* v. *Commissioner*, 6 Cir., 1959, 265 F. 2d 498, 502; *Thomas* v. *Commissioner*, 1 Cir., 1956, 232 F. 2d 520, 525; *Thomas* v. *Commissioner*, 6 Cir., 1955, 223 F. 2d 83. Both *Thomas* cases were approved and followed by this Court in *Phillips' Estate* v. *Commissioner*, 5 Cir., 1957, 246 F. 2d 209; see also the final action by the 6th Circuit in the latest appeal of the *Thomas* case, *Thomas* v. *Commissioner*, 6 Cir., 1959, 266 F. 2d 297; *Veino* v. *Fahs*, 5 Cir., 1958, 257 F. 2d 364; *Gunn* v. *Commissioner*, 8 Cir., 1957, 247 F. 2d 359; *Harp* v. *Commissioner*, 6 Cir., 1959, 263 F. 2d 139."

that there be adequate evidence[4] to support a determination that the true income is represented by the process of reconstruction. But once that is satisfied, neither the method nor the evidence undergoes an added scrutiny because the taxpayer's books are to this extent disregarded. Indeed, the determination that the trier of fact had requisite basis for concluding that income was truly that shown by the reconstruction process is a simultaneous determination that no matter how neatly or diligently or consistently or conscientiously kept, the books and records were inadequate. * * *"

The Commissioner's determination of a deficiency is prima facie correct, and the burden is upon the taxpayer to disprove that determination. *Marcella* v. *C. I. R.*, 222 F.2d 878; *Lusk* v. *C. I. R.*, 250 F.2d 591.

Because a physical head count of cattle was never made prior to September, 1947, that no books were kept of the cattle feeding operations and that even petitioner and his accountant estimated the livestock carry-over each year, resort to the net worth method was necessitated. The principal item here in dispute is the cost of livestock on hand at the beginning of each year for which the instant deficiencies were determined. The petitioner in this court, as in the Tax Court, vigorously attacks the Commissioner's use of the ninety day cutoff to establish cost of cattle carried over into the succeeding year. The Tax Court held that the Commissioner was not only justified in adopting this method but that petitioner's lack of records

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"[4] The standard for appeals from the Tax Court is the clearly erroneous concept under F.R. Civ. P. 52(a) for appeals from nonjury trials in the District Court. See 26 U.S.C.A. § 7482. Appeals from judgments entered in a jury trial are reviewed under the familiar substantial evidence rule. *Marsh* v. *Illinois Central R. Co.*, 5 Cir., 1949, 175 F. 2d 498."

compelled it. We agree. The method used by the petitioner and his accountant in arriving at the year end cost of the cattle on hand was similar to that used by the Commissioner. In net worth cases the fact finder is warranted in bearing heavily against the contentions of the taxpayer whose inexactitude is of his own making, and where the findings are based upon the entire record, they cannot be said to be clearly erroneous. *Gatling* v. *C. I. R.*, 286 F.2d 139.

In holding that part of the deficiencies for each of the years 1944 through 1946 was due to fraud with intent to evade tax, the Tax Court recognized that the burden rested upon the Commissioner to prove fraud by clear and convincing evidence. §1112, Internal Revenue Code of 1939. Fraud is a question of fact, and the Tax Court finding is binding if supported by substantial evidence. *Helvering* v. *Kehoe*, 309 U.S. 277, 60 S.Ct. 549, 84 L.Ed. 751; *Bender* v. *C. I. R.*, 256 F.2d 771.

In the case before us the Tax Court had this to say concerning the fraud issue:

> "* * * The burden rests upon the respondent to prove fraud by clear and convincing evidence. *Arlette Coat Co.*, 14 T.C. 751. There were consistent understatements of income of a substantial nature over the years before us. Petitioner reported income for the years 1944, 1945, 1946 and 1947 in the sums of $487, $11,840, $51,500 and $249,506, respectively. The completely unrealistic nature of his reported income is graphically demonstrated by the net worth computation and the profit and loss statement prepared by respondent, which computations we have, on the basis of the entire record, sustained, and which show unreported income for the years 1944, 1945, 1946 and 1947 in the amounts of $163,609, $148,379, $364,140 and $61,149, respectively. Such a pattern of repeated gross understatements of income without adequate

explanation is evidence of fraudulent intent. *Schwarzkopf* v. *Commissioner*, .. F.2d .. (July 10, 1957), affirming a Memorandum Opinion of this court; *Kilpatrick* v. *Commissioner*, 227 F.2d 240, affirming 22 T.C. 446. We are persuaded from the impressive growth in the scope of petitioner's operations and from the financial statements filed by petitioner with his bank over these years, that the petitioner was fully aware that his income was not accurately reported in his returns for those years. Our findings reveal a marked discrepancy between the small amounts of taxable income reported by petitioner in those years and the amounts as determined by the respondent in his net worth computation.

"Another strong indication of fraud on petitioner's part is the matter of the altered checks. Approximately 20 checks were made out by petitioner for payment of real estate purchased by him in each of the years 1944, 1945 and 1946. After these checks were cashed, notations regarding real estate were erased and new notations were placed on the checks indicating that the amounts were payment for corn, fodder and other operating expenses. Petitioner, in 1946, purchased a Reo truck at a price of $2,638.49, which amount he paid by check. In the lower left hand corner of the check a notation was made that it was in payment for approximately 1,600 bushels of corn at $1.65. It is to be noted that, for the most part, the notations indicated that the full amount of the check was for these various operating expenditures. This reveals the weakness in petitioner's attempt to explain such notations by saying that they resulted from an attempt to find out what portion of each real estate purchase represented non-real estate items. It fairly appears that petitioner deducted as an operating expense for the years involved the amounts indicated on the altered checks. Petitioner

conducted large scale feeding operations during the years here involved, and he impressed us as an intelligent businessman. We hold, after an examination of the entire record, that a part of the deficiencies for each of the years 1944 through 1947 was due to fraud with intent to evade tax." (Note: Only the years 1944 through 1946 are involved in this appeal).

We cannot say the Tax Court was in error. The holding that petitioner failed to file a return for the year 1946 as required by 51(a), Internal Revenue Code of 1939, was based upon the finding that no computations or schedules were shown on the return which was blank except for a net income figure and the amount of tax due thereon. No evidence was offered to show that failure to file was due to reasonable cause and not willful neglect. We think the problem was well stated by the 9th Circuit in *Ferrando* v. *United States*, 245 F.2d 588 when that Court said.

"• • • the filing of an admittedly incomplete, inaccurate, and estimated return does not of itself relieve the tardy taxpayer of liability for a penalty. If such an excuse were accepted, it would put a premium upon belated and slipshod filing. A careless and neglectful taxpayer could wait until the last minute, present an amorphous return and escape the penalty. We do not believe that such is the genius and spirit of the Federal estate tax law. Congress did not intend that taxpayers should be perimitted thus to play ducks and drakes with the collection of the Federal fisc.

"A similar situation confronted the Court of Appeals for the Tenth Circuit in *Sanders*, supra, 225 F.2d at page 637. There is was said:

"'The taxpayers filed tentative or skeleton returns which contained no detailed information as

to income or deductions. The completed returns were not filed until a number of years after the due date. The taxpayers' books were not posted and an effective audit could not be made. The last payments from the United States were received by Sanders in 1949, and a return was not filed until September of 1952, after notice of deficiencies had been given and the liens had been filed. *The record discloses sufficent evidence to sustain the decision of the Tax Court in upholding the assessment of penalties and interest.*' [Emphasis supplied.]"

Petitioners here having failed to meet their burden of establishing that the failure to file a return was due to reasonable cause and because the defective return filed before the due date was not sufficient to protect the petitioners here from the addition, there is no reason for this court to disturb the decision of the Tax Court of the United States.

We have considered other questions raised herein but find none of such substance or merit as to require discussion. Finding no reversible erorr, the judgment of the Tax Court is

Affirmed.

(SEAL)
A true copy.
Attest:

ROBERT C. TUCLIN
Clerk, U. S. Court of Appeals, Eighth Circuit.